What is a Non-Equity Partner?

Phillip L. Jelsma

"When I started writing I thought if I proved X was a stupid thing that people would stop doing X."
"I was wrong." - Bill James, 1984 Baseball Abstract.

Phillip L. Jelsma
Mr. Jelsma is a partner in the Carmel Valley / Del Mar office of Luce Forward LLP. He practices in corporate, limited liability company, and partnership income tax planning with and emphasis on mergers and acquisitions.

What is a non-equity partner? There are a number of possible answers. Some of the possible answers are:

(a) an oxymoron;

(b) an employee who has agency authority to bind a partnership but lacks vicarious liability for partnership debts;

(c) a person who on termination can either argue for wrongful termination damages or breach of fiduciary duties;

(d) every "partner" in a large law firm;

(e) the worst of all possible worlds; or

(f) all of the above.

There is no legal definition of a "non-equity partner." Perhaps this is because California law does not define "partner." Corporations Code 16101, subdivision (2) defines a partnership as an association of two or more person to carry on as co-owners of a business for profit. Case law indicia are the co-ownership of the property, profit sharing, management, and control capital contributions. (*Holmes v. Lerner* (1999) 74 Cal.App.4th 442.)

In *Chambers v. Kay* (2002) 29 Cal.App.4th 142, the California Supreme Court looked at two attorneys fighting over a contingent fee. The attorneys had separate law practices in San Francisco with individual letterheads. They did not list each other as an employee or a partner in any official documents. Kay paid Chambers $200 a month for use of a conference room and also paid Chambers for telephone service, all library services, postage, and copying. Kay maintained separate files and computer in his office. At Kay's request, Chambers began to serve as co-counsel on a sexual harassment case that eventually ended in a dispute where Kay notified Chambers that he had been removed as co-counsel. After a substantial settlement was received, a dispute arose between the respective lawyers concerning the division of fees.

The court focused on Rules of Professional Conduct, rule 2-200 which provides "a member shall not divide a fee for legal services with a lawyer who is not a partner of, associate of, or shareholder with a member unless: the client has consented in writing therewith after full disclosure has been made that the division of fees will be made with the terms of such division; and the total fee charged by all lawyers is not increased solely by reason of the provision of the division of fees and it's not unconscionable as that term is defined in Rule 4-200." In determining whether Chambers and Kay were partners, the court looked to Corporations Code section 16101 quoted above, finding there were no attributes of partnership such as co-ownership of assets, division of profits, participation in management decisions, control, contributions, and/or contributions to capital. Thus, the court concluded that the attorneys involved were not partners. Using the same analysis, most non-equity partners would not be characterized as partners under California law since they do not make capital contributions, share in profits or losses, or participate in management decisions.

Nevertheless, a non-equity partner can incur liabilities on behalf of the partnership. Corporations Code section 16308, subdivision (b) provides,

> If a person is thus represented to be a partner in an existing partnership, or with one or more persons not partners, the purported partner is an agent of persons consenting to the representation to bind them in the same manner in the same extent as if the purported partner, were a partner, with respect to persons who enter into transactions in reliance upon the representation. If all of the partners of the existing partnership consent to the representation, a partnership act or obligation results.

Therefore, any act by the non-equity partner may obligate the partnership and incur a partnership liability. However, by its terms, section 16308, subdivision (b) does not apply to limited liability partnerships ("LLP"), but an LLP may be bound to obligations using general principles of ostensible authority or ratification. Corporations Code section 16301, subdivision (1) provides:

> Each partner is an agent of a partnership for purposes of its business. An act of a partner, including the execution of an instrument partnership name, for apparently carrying on in the ordinary course the partnership business or business of the kind carried out by the partnership binds the partnership, unless the partner has no authority to act for the partnership in that particular manner and the person with whom the partner was dealing knew or had to see the notification that the partner lacked authority.

Civil Code section 2317 provides that an agent or employee has ostensible authority if the principal intentionally or by lack of ordinary care, causes or allows a third person to believe the agent possesses such authority. Therefore, it is clear that the non-equity partner can bind or incur liability on behalf of the partnership.

However, the non-equity partner may not be liable for the resulting partnership debt. Under Corporations Code section 16306, subdivision (a), partners are jointly and severely liable for the obligations of the partnership unless otherwise agreed by the claimant or provided by law. However, a non-equity partner would not typically satisfy the definition of partner under the Corporations Code and therefore would have no liability for the debt incurred by his or her acts.

The prestigious firm of Sidley Austin Brown & Wood has seen the potential adverse consequences of non-equity partners. As recently as February 17, 2006, Sidley & Austin lost its fifth consecutive reported decision concerning its 1999 demotion of 31 of its equity partners to "of counsel" or "senior counsel" status. The Equal Opportunity Commission ("EEOC") began an investigation to determine whether the demotions might have violated the Age Discrimination and Employment Act ("ADEA"), specifically, to determine whether the attorneys were partners consistent with their titles or merely employees. The Seventh Circuit upheld the U.S. District Court's subpoena of documents in the investigation in *EEOC v. Sidley Austin Brown & Wood* (7th Cir. 2002) 315 F.3d 696. The EEOC then filed a ADEA suit against Sidley, which resulted in a motion for partial summary judgment which was denied by the District Court . The District Court's decision was upheld by the Seventh Circuit, 2006 Lexis 3800 (February 17, 2006). Following the February 17th decision, the District Court will consider money damages for the "de-equitized" partners. At the heart of the EEOC's suit is that the lawyers demoted by Sidley in 1999 held the title of partner but were in fact employees of the firm. While the federal anti-discrimination laws do not apply to partners, they do apply to employees. What is somewhat difficult about the 2002 Seventh Circuit decision (where the court ordered the law firm to comply with the EEOC's subpoena), is that the court looked at Sidley's management structure and suggested that the bulk of its partners were in fact employees. The court noted that the firm consisted of 500 partners, but was run by a committee of three--indicating that the firm was not a partnership. The most "partnershipesque" feature was the partners' personal liability for partnership debts, which in fact is somewhat irrelevant since Sidley & Austin is a limited liability partnership. The clear implication is that individuals who are called partners, but who do not have a meaningful voice or vote in management, may be employees. At issue, these were equity partners converted to non-equity. If "equity partners" were protected by the ADEA, it is highly likely that non-equity partners would be protected as well.

As a partnership lawyer, it never ceases to amaze me how law firms who analyze corporate issues and problems in painstaking detail for their clients, willingly accept the recommendations of consultants and create a class of non-equity partners without carefully considering the collateral consequences which may flow from creating a position with ambiguous legal status. Our firm accepted a recommendation from a consultant to create non-equity partners simply to improve *American Lawyer* profits per partner statistics. I learned from asking questions of another consultant that all the other firms he had as clients were doing the same, and all of those firms recognized that the profits per partners statistics were manipulated by the use of non-equity partners. As a result, the only conclusion that could be reached is that the profits per partner numbers were artificial and meaningless, yet law firms who are willing to do this put themselves at risk, for what? More importantly, what does profits per partner generally say about a firm? Would a firm terminate 50% of its administrative staff to improve profits per partner? Would lawyers who bill 2,000 hours per year change firms to increase their profits per partner if it turns out to be a partner in the second firm they had to bill 3,000 hours per year? What do profits per partner tell us concerning the partner's satisfaction with their position, their relationship with their associates and partners, their personal or professional goals, the risks associated with their practices and their client responsibilities? Wouldn't it make more sense for the legal profession to develop a more appropriate measure of profitability or job satisfaction than profits per partner?

If a client proposed calling an employee a partner, granting apparent authority to incur liabilities while still subjecting the client to federal and California labor laws, for the sole reason of inflating its industry statistics, what would you recommend? ■